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Real estate industry developments - 1995/96; Audit risk alerts

American Institute of Certified Public Accountants

AUDIT RISK ALERTS

Real Estate Industry Developments—1995/96

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NOTICE TO READERS

This Audit Risk Alert is intended to provide auditors of financial statements of real estate enterprises with an overview of recent economic, industry, regulatory, and professional developments that may affect the audits they perform. This document has been prepared by the AICPA staff. It has not been approved, disapproved, or otherwise acted on by a senior technical committee of the AICPA.

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Industry and Economic Developments

The state of uncertainty that has existed in the real estate industry, as well as the economy in general, continues in 1995. In the 1980s and early 1990s, the U.S. real estate industry experienced a significant downturn as a result of the slowdown of the economy in general. Since the bottom of the downturn, the industry has been anticipating a full recovery. Each year, however, economic, demographic, and structural factors combine to defer the recovery. For instance, trends toward corporate downsizing and telecommuting in recent years have had an unfavorable effect on the commercial market, because businesses need less space. Corporate downsizings also have affected the residential market, as employees affected by these downsizings have seen their ability to save for housing eroded.

Although certain positive trends continue to emerge (for instance, office vacancy rates are down, and housing starts are increasing), there are wide variances among regions and different kinds of property. Auditors should be aware of the economic conditions that affect real estate markets in regions in which their clients operate, and not just in the location in which the client's headquarters are located.

In the 1980s and early 1990s, the commercial markets (particularly office buildings and strip malls) experienced an oversupply of space. The primary factors contributing to oversupply were the general economic recession, a trend toward corporate downsizing, and the changing demographics of many entities. As the general economy faltered, many businesses downsized their operations through staff reductions, work-at-home programs, and so forth. Those cost reductions affected the need for office space adversely. As a result, building slowed drastically.

When the economy improved during 1994, the demand for commercial space increased. That demand was met by available space, and no more than a limited level of new building was required. By the end of 1994, downtown office-vacancy rates decreased to their lowest levels of the 1990s, and suburban vacancy rates hit an all-time low. As the general economy continued to improve in 1995, the commercial markets in a number of areas throughout the country also continued to show improvement. The increased occupancy rates, combined with the eased restrictions on lending in many areas, have raised fears that the industry may react so quickly that a repeat of the disastrous overbuilding of the 1980s recurs. Many in the industry believe that, although occupancy rates are increasing, they are not yet at a level that would justify a surge in new construction.

In the residential market, more single-family homes were built in 1994 than in any of the past fifteen years. However, the downward trend in demand that started near the end of last year persisted during the first quarter of 1995. In recent months, housing starts began to rise again, mainly in response to increased demand resulting from lower mortgage rates. Also, permits for new construction have increased in recent months, indicating that the rebound may be maintained throughout the year.

However, the optimism related to the rebound is somewhat tempered by the fact that the strength is highly concentrated in the Southern United States. Other regions have experienced either a flat market or declines.

Throughout the early 1990's, the real estate industry experienced a marked increase in the formation of real estate investment trusts (REITs). For owners and developers, REITs provide an alternative method of raising capital in tight credit markets. For investors, REITs offer a securitized investment that may be an attractive vehicle for increasing investment yields. As discussed in the "Audit Issues and Developments" section of this Audit Risk Alert, auditors should be aware of recent developments in the REIT marketplace that may indicate going-concern or asset-valuation issues.

AICPA Statement on Auditing Standards (SAS) No. 22, *Planning and Supervision* (AICPA, *Professional Standards*, vol. 1, AU sec. 311), requires that in planning their audits, auditors consider matters that affect the industry in which the entity operates, such as the economic factors. With respect to audits of real estate entities, this would include the commercial and residential market factors described above. These factors also have affected real estate values. Although overall values have been increasing slightly, the values of many properties have not returned to their prerecession levels. Decreases in equity have led some owners to abandon their properties and precipitated a number of foreclosures by financial institutions and other lenders. Because they were unwilling owners, these financial institutions have sold foreclosed properties at fire-sale prices, which exerted downward pressure on real estate values. As a result, credit had been nearly unavailable to the real estate industry, except for projects with proven economic viability. More recently, however, real estate values have maintained their slow upward trend, however, and lending activity has once again increased.

The availability of credit has resulted in increased levels of construction in many markets, which also contributes to the fears of overbuilding.

Regulatory Developments

Real estate entities and the transactions in which they engage have become the focus of an increasing level of government regulation. SAS No. 22 also requires that in planning their audits, auditors should obtain a knowledge of matters that relate to the entities' business, including, among other things, government regulations. Auditors should consider such regulations in light of their potential effect on the financial statements being audited. SAS No. 54, *Illegal Acts by Clients* (AICPA, *Professional Standards*, vol. 1, AU sec. 317), distinguishes between the following two kinds of laws and regulations:

1. Those that have a direct and material effect on the determination of financial statement amounts
2. Those that relate more to an entity's operating aspects than to its financial and accounting aspects and, therefore, have only an indirect effect on the financial statements

Although auditors should design their audits to provide reasonable assurance of detecting material misstatements of the financial statements resulting from illegal acts that have a direct and material effect on the determination of financial statement amounts, an audit performed in accordance with generally accepted auditing standards (GAAS) normally does not include procedures specifically designed to detect illegal acts that would have only an indirect effect on the financial statements. Nonetheless, auditors should be aware of the possibility that such illegal acts may have occurred.

Specific laws and regulations that may affect the real estate industry are discussed in the following paragraphs.

U.S. Department of Housing and Urban Development Regulations

Through the Federal Housing Administration, the U.S. Department of Housing and Urban Development (HUD) regulates the development and operation of all of the housing projects for which it insures mortgages or provides rent subsidies. Entities that receive financial assistance from HUD are required to submit audited financial statements to HUD annually. Those audits are required to be performed in accordance with GAAS, *Government Auditing Standards* issued by the Comptroller General of the United States (also commonly referred to as the "Yellow Book"), and the *Consolidated Audit Guide for HUD Programs,* issued by the HUD Office of the Inspector General (OIG).

HUD Audit Guide. In July 1993, the HUD OIG issued a revised *Consolidated Audit Guide for Audits of HUD Programs* (the revised Guide), which is effective for audits of financial statements for fiscal years ending on or after September 30, 1993. The revised Guide provides program-specific audit requirements for entities that—

- Participate in HUD Section 8 programs
- Participate in insured and coinsured multifamily projects
- Have insured development certifications
- Issue Government National Mortgage Association mortgage-backed securities
- Are HUD-approved title II nonsupervised mortgagees and loan correspondents
- Are HUD-approved title I nonsupervised lenders and loan correspondents

Further significant changes in the revised Guide include the incorporation of final rules (dated December 9, 1992) for mortgage approval reform and direct-endorsement expansion as well as for implementing Office of Management and Budget Circular A-133, *Audits of Institutions of Higher Education and Other Nonprofit Institutions.* The revised Guide also deletes the common compliance requirements contained in the prior guide and provides revised suggested audit procedures for testing compliance with laws and regulations. Auditors should be aware of the revised Guide's requirements when planning and performing HUD audits.

Illustrative auditor's reports for HUD audits are included in the appendix to this Audit Risk Alert.

Government Auditing Standards. Auditors who perform HUD audits should also be alert to the 1994 Revision of *Government Auditing Standards.* The 1994 Revision provides guidance (rather than requirements) for the auditor's consideration of internal controls for control environment, safeguarding controls, controls over compliance with laws and regulations, and control risk assessment. It does not establish new responsibilities for testing controls. Further, the 1994 Revision—

- Adds a requirement for audit organizations to provide a copy of their most recent external quality control review report to parties seeking to contract for an audit

- Sets a new benchmark for the sufficiency of working papers. Working papers should enable an experienced auditor to ascertain from them the evidence that supports the significant conclusions and judgments. It explicitly requires the working papers to include descriptions of transactions and records examined so that an experienced auditor would be able to examine the same transactions and records

- Adds a requirement for auditors to communicate their responsibilities for consideration of internal controls and compliance with laws and regulations to audit committees or the individuals with whom they have contracted for the audit

- Adds a requirement to include a reference to *Government Auditing Standards* in audit reports when they are being submitted in accordance with a law or regulation calling for an audit in accordance with *Government Auditing Standards*

- Adds a requirement that the report on the financial statements either (1) describe the results of the auditor's tests of internal controls and compliance or (2) refer to separate reports on controls and compliance

- Clarifies a requirement that the auditor report irregularities and illegal acts directly to parties outside the client, in certain circumstances, even if he or she has resigned or been dismissed from the audit

- Clarifies a requirement that auditors report all irregularities and illegal acts except for those that are clearly inconsequential

- Adds a requirement to design the audit to provide reasonable assurance of detecting noncompliance with contract provisions and grant agreements that could have a direct and material effect on financial statement amounts

- Deletes the requirement to describe categories of internal controls in reporting on internal controls

- Deletes the requirement to express positive and negative assurance on compliance with laws and regulations

- Incorporates relevant AICPA SASs, for example, SAS No. 62, *Special Reports* (AICPA, *Professional Standards*, vol. 1, AU sec. 623), and attestation standards into *Government Auditing Standards* for financial-related audits

Auditors should be mindful that *Government Auditing Standards* also includes general standards, such as standards for continuing professional education and the auditor's participation in external quality control review programs.

Compliance Auditing Considerations in Audits of Governmental Entities and Recipients of Governmental Financial Assistance. Auditors of real estate entities that are recipients of governmental assistance also should consider the guidance set forth in SAS No. 74, *Compliance Auditing Considerations in Audits of Governmental Entities and Recipients of Governmental Financial Assistance* (AICPA, *Professional Standards,* vol. 1, AU sec. 801). SAS No. 74, which supersedes SAS No. 68, *Compliance Auditing Applicable to Governmental Entities and Other Recipients of Governmental Financial Assistance,* is effective for audits of financial statements and of compliance with laws and regulations for fiscal periods ending after December 31, 1994. SAS No. 74 provides general guidance to practitioners engaged to perform compliance audits of recipients of governmental financial assistance.

SAS No. 74 continues to recognize three levels of audits—GAAS, *Government Auditing Standards,* and certain other federal requirements—of recipients of governmental financial assistance. SAS No. 74 is applicable when the auditor is engaged to perform an audit under GAAS, *Government Auditing Standards,* and in certain other circumstances involving governmental financial assistance, such as single or organization-wide audits or program-specific audits under certain federal or state audit regulations. SAS No. 74 also provides general guidance to the auditor to:

- Apply the provisions of SAS No. 54, relative to detecting misstatements resulting from illegal acts related to laws and regulations that have a direct and material effect on the determination of financial statement amounts in audits of the financial statements of governmental entities and other recipients of governmental financial assistance.

- Perform a financial audit in accordance with *Government Auditing Standards.*

- Perform a single or organization-wide audit or a program-specific audit in accordance with federal audit requirements.

- Communicate with management if the auditor becomes aware that the entity is subject to an audit requirement that may not be encompassed in the terms of his or her engagement.

Interstate Land Sales and Full Disclosure Act

Developers are required to make certain disclosures in connection with the sale or lease of certain undeveloped subdivided land. The Interstate Land Sales and Full Disclosure Act (the Act) makes it unlawful for a developer to sell or lease, by use of the mail or any other means of interstate commerce, any land offered as part of a common promotional plan unless the land is registered with the Office of Interstate Land Sales Registration. The Act requires that a printed property report be furnished to all prospective purchasers or lessees. Similarly, the Federal Trade Commission has the authority to act on unfair or deceptive trade practices with respect to real estate sales, particularly as they relate to the marketing and selling activities of real estate companies.

Regulation Z of the Consumer Credit Protection Act

Since most real estate purchases are made on credit, truth-in-lending laws can have a significant effect on real estate financing transactions. Regulation Z of the Consumer Credit Protection Act prescribes requirements for both creditors and borrowers for full disclosure of credit costs and is applicable to all real estate transactions, regardless of amount, in which individual borrowers are involved. Certain provisions of truth-in-lending laws and regulations may affect the manner in which interest related to real estate financing transactions should be calculated. As such, violations of such laws could cause a material misstatement of the financial statements of real estate enterprises that finance such transactions. See SAS No. 54 for further discussion of the auditor's responsibilities regarding illegal acts.

Tax Matters

The Omnibus Budget Reconciliation Act of 1993 permits real estate entities, for taxable years beginning in 1994, to offset net losses from rental real estate activities (previously treated as passive-income losses) in which they materially participate against income from other sources. Material participation has the same meaning as under prior law. The most common method of achieving material participation in an activity is to work more than 500 hours in the activity in the taxable year. Other ways to achieve material participation in a rental real estate activity are to (1) perform substantially all of the participation in the activity, even if less than 100 hours, or (2) have more than 100 hours of participation in the activity and have more hours than anyone else. Limited partners, however, can meet the material participation test for real estate only through the 500-hour test.

Each hour of participation in a real-property trade or business can count for all of the tests for relief under the new law. Real property trades or businesses that meet the requirements of these tests are defined as any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental operation, management, leasing, or brokerage trade or business. Auditors should be aware of the impact that the Omnibus Budget Reconciliation Act of 1993 may have on the calculations of entities' tax provisions and the potential resulting effect on financial statements.

Audit Issues and Developments

General Risk Factors

Although conditions vary from region to region and entity to entity, general factors inherent in the real estate industry that influence audit risk include the following.

Magnitude and Complexity of Transactions. The financial statements of real estate companies generally include a large number of highly complex transactions. The complexity of these transactions is increased by the fact that a number of them are based on estimates.

Lengthy Development/Holding Periods. By their nature, real estate projects involving construction require significant lead time. Delays may result in increased costs and potentially affect the net realizable value of the assets being constructed.

Financing and Liquidity Concerns. Real estate enterprises are often highly leveraged, creating concerns about the ability of entities in the industry to continue to obtain adequate capital and to meet obligations as they come due. Auditors should carefully consider these industry-specific conditions and assess the effect they have on audit risk.

Asset Impairment

Impairment of assets continues to be a major concern throughout the real estate industry and requires critical attention in the audits of financial statements of real estate entities. Financial Accounting Standards Board (FASB) Statement No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of* (FASB, *Current Text,* vol. 1, sec. I08), has particular importance in the real estate industry. As discussed in the "Accounting Developments" section of this Audit Risk Alert, FASB Statement No. 121 revises significantly the way in which entities will account for real estate. It requires different accounting for impaired assets based on whether those impaired assets are "to be held and used" or "to be disposed of."

Auditors should obtain reasonable assurance that management has considered all relevant factors in determining whether asset impairment has occurred. The subjectivity of determining the adequacy of the impairment adjustment reinforces the need for careful planning and execution of audit procedures in this area.

Conditions such as the following may indicate a need for adjustment of the amount at which investments in real estate are being carried.

- Cash flows from operating activities are insufficient to cover debt service.
- Current occupancy rates indicate that future cash flows to be received are lower than the amounts needed to fully recover the carrying amount of the investment.
- Major tenants have experienced or are experiencing financial difficulties.
- A significant portion of leases will expire in the near term.
- Lessors are being forced to make significant concessions in order to rent property.
- Properties held for sale remain unsold at subsequent balance sheet dates.
- Other investors have decided to cease providing support or to reduce their financial commitment to a project or venture.
- Auditors' reports on financial statements of investee properties or significant debtors are modified for reasons that relate to real estate investments or mortgage loans. Examples of such reports may include the following.
  - — An auditor's report on the financial statements of investee properties is modified for a departure from generally accepted accounting principles (GAAP) due to improper valuation of assets.
  - — An auditor's report on the financial statements of a significant debtor is modified for going-concern considerations, indicating that the debtor may not be able to meet its obligations.

Lack of an asset-impairment evaluation system or failure of a real estate entity to document adequately its criteria and methods for determining whether impairments have occurred may indicate a reportable condition in the entity's internal control structure. Further, a lack of documentation generally will increase the extent to which judgment must be applied by auditors in evaluating the adequacy of management's writedowns and will increase the likelihood that differences will result. The AICPA Audit and Accounting Guide *Guide for the Use of Real Estate Appraisal Information* provides guidance to help auditors understand real-estate appraisal concepts and information. SAS No. 57, *Auditing Accounting Estimates* (AICPA, *Professional Standards*, vol. 1, AU sec. 342), should be followed in auditing estimates such as impairments.

Auditors should also consider the propriety of the client's classification of assets as "held for sale" or "held for investment." Land to be developed and projects under development should be accounted for in accordance with paragraphs 4 through 7 of FASB Statement No. 121 (that is, they should be considered *assets to be held and used*). Completed projects should be accounted for in accordance with paragraphs 15 through 17 of the Statement *(assets to be disposed of)*.

Another source of guidance on auditing estimates of real estate entities is SAS No. 73, *Using the Work of a Specialist* (AICPA, *Professional Standards*, vol. 1, AU sec. 336). SAS No. 73 is effective for audits of periods ending after December 15, 1994. SAS No. 73 supersedes SAS No. 11, *Using the Work of a Specialist.*

Direct Investments in Real Estate Properties

Real estate held for investment should be reported at cost, less accumulated depreciation, and should be evaluated for impairment if facts and circumstances indicate that impairment may have occurred, in conformity with the provisions of paragraphs 4 through 7 of FASB Statement No. 121. An impairment is deemed to have occurred if the carrying amount of the asset exceeds the sum of the expected future cash flows (undiscounted and without interest charges from the asset). The impairment is measured as the amount by which the carrying amount exceeds the fair value of the asset. After an impairment is recognized, the reduced carrying amount of the asset should be accounted for as the new cost of the asset and depreciated over the remaining useful life (for depreciable assets). Restoration of previously recognized impairment losses is prohibited.

In assessing the need for adjustment of the amount at which direct investments in real estate are being carried, auditors should be alert for conditions that might indicate that impairments have occurred, such as those discussed in the "Industry and Economic Developments" section of this Audit Risk Alert, and those listed in paragraph 5 of FASB Statement No. 121.

Real Estate to Be Disposed Of

All real estate to be disposed of that is not subject to the provisions of Accounting Principles Board (APB) Opinion No. 30, *Reporting the Results of Operations—Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions* (FASB, *Current Text,* vol. 1, sec. I13), for which management, having the authority to approve the action, has committed to a plan of disposal, should be reported at the lower of carrying amount or fair value less costs to sell. Subsequent revisions to fair value less costs to sell should be reported as adjustments to the carrying amount of the asset to be disposed of. However, the carrying amount may not be adjusted to an amount greater than the carrying amount of the asset before an adjustment was made to reflect the decision to dispose of the asset.

In assessing the valuation of assets to be disposed of, auditors should consider various issues, including the following:

- Is the asset appropriately identified as subject to FASB Statement No. 121, or should APB Opinion No. 30 be applied?
- Has management committed to the plan of disposal? Was the commitment made by management with the authority to approve the action?
- Has fair value been determined using reasonable assumptions and estimates?
- Has the client included only appropriate costs in the estimate of costs to sell? Have the costs to sell been discounted, where appropriate?

Foreclosed and In-Substance Foreclosed Real Estate

AICPA Statement of Position (SOP) 92-3, *Accounting for Foreclosed Assets,* provides guidance on measuring foreclosed assets after foreclosure. In accordance with SOP 92-3, there is a rebuttable presumption that foreclosed assets are held for sale. The SOP requires foreclosed assets held for sale to be carried at the lower of fair value minus estimated costs to sell or cost. Foreclosed assets held for the production of income should be treated the same way they would be had they been acquired in a manner other than foreclosure. The SOP refers to FASB Statement No. 15, *Accounting by Debtors and Creditors for Troubled Debt Restructurings* (FASB, *Current Text,* vol. 1, sec. D22), for its definition of fair value. In considering the appropriateness of fair values, auditors of publicly held entities should consider the guidance in Section 401.09d of the Securities and Exchange Commission's (SEC's) *Codification of Financial Reporting Policies,* which indicates that the mere adoption of strategies such as hold-for-the-future strategy based on expectations of future price increases, or a strategy of operating repossessed collateral on one's own behalf, cannot justify the use of derived accounting valuations that portray the results of operations more favorably than would the use of current values in active markets.

Certain provisions of SOP 92-3 are inconsistent with the provisions of FASB Statement No. 121. The AICPA's Accounting Standards Executive Committee (AcSEC) is considering actions that it should take on SOP 92-3; however, FASB Statement No. 121 takes precedence for transactions within its scope.

Revenue Recognition

In light of the fact that the industry's persistently optimistic outlooks have not yet fully materialized, combined with the economic indicators reflecting increasing consumer confidence, auditors should consider the appropriateness of their clients' revenue-recognition policies, or changes therein. The increased level of consumer confidence may lead to clients' forecasting improvements in financial results when in fact financial results may not be as positive. A number of clients may view the recent improvement in the general economy, the increasing consumer confidence, and the related heightened optimism within the industry as an opportunity to present improved financial results through changes in operating or accounting policies that affect the timing or propriety of revenue recognition. In evaluating the revenue recognition policies of real-estate-industry clients, auditors should consider carefully whether the criteria set forth in FASB Statement No. 66, *Accounting for Sales of Real Estate* (FASB, *Current Text,* vol. 1, sec. R10), have been met. Auditors should consider the facts and circumstances surrounding property sales carefully to be certain that there are no formal or informal "put" arrangements committing the seller, its officers, or its shareholders to repurchase the property, find other buyers, or indemnify the buyer or third-party guarantors for risk of loss. Auditors should also consider circumstances that would indicate that a seller may have directly or indirectly provided the funds for a down payment (or for the entire purchase price) in a cash sale. Apart from precluding the use of the full accrual method of profit recognition, such circumstances may create relationships that meet the definition of related parties as set forth in FASB Statement No. 57, *Related Party Disclosures* (FASB, *Current Text,* vol. 1, sec. R36). SAS No. 45, *Omnibus*

Statement on Auditing Standards—1983, "Related Parties" (AICPA, *Professional Standards,* vol. 1, AU sec. 334), describes procedures that are designed to determine the existence of related parties as defined by FASB Statement No. 57.

Availability of Funding

Real estate entities require substantial amounts of capital. Although lending activity appears to be on the rise, it is not at the level of the 1980s. As a result of the prolonged slump in the industry, and losses incurred in recent years, a number of the traditional sources of capital for the industry are no longer lending in the amounts they did previously. Financial institutions have become more selective in their real estate lending, a tendency that is attributable partly to recent losses, as well as to increased regulatory scrutiny. Moreover, sluggish global economic conditions have kept foreign investors from becoming an alternative source of funds.

SAS No. 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern* (AICPA, *Professional Standards,* vol. 1, AU sec. 341), describes an auditor's obligation to evaluate whether there is substantial doubt about an entity's ability to continue as a going concern for a reasonable period of time, not to exceed one year beyond the date of the financial statements being audited. SAS No. 59 includes the "need to seek new sources or methods of financing" as an example of a condition or event that indicates there could be substantial doubt about the entity's ability to continue as a going concern for a reasonable amount of time.

Deferred Rents

Although office vacancies appear to be decreasing, occupancy has not improved enough to drive up rents. The perception that it is a renter's market persists, and rent abatements and other enticements continue to be offered. FASB Statement No. 13, Accounting for Leases (FASB, Current Text, vol. 1, sec. L10), requires that rents be recognized on a straight-line basis over the term of the lease even if payments are not made on a straight-line basis. Because of the number and magnitude of rent abatements and concessions being offered, significant deferred rent balances are sometimes recorded. In auditing such balances, auditors should consider carefully the reasonableness of assertions by management concerning the ability of tenants to perform according to the lease agreement. If tenants are unable to perform according to the lease agreement, deferred rents may not be fully recoverable.

Environmental Issues

The U.S. Environmental Protection Agency (EPA) is empowered by law to order any party that owned or operated a site currently included on the National Priorities List, or anyone who has arranged for disposal or transported hazardous materials to such a site, to remediate the site or to reimburse the EPA for remediation costs and pay additional damages. In many states, state agencies have powers similar to the EPA's with respect to contaminated sites. In view of the liabilities that may be incurred from owning contaminated sites, virtually all entities entering into real estate transactions today consider potential environmental liabilities.

Auditors of real estate entities that face such claims should evaluate carefully whether the accounting and disclosure requirements of FASB Statement No. 5, *Accounting for Contingencies* (FASB, *Current Text,* vol. 1, sec. C59), have been met. Auditors should also be aware of the consensus reached in FASB Emerging Issues Task Force (EITF) Issue No. 93-5, *Accounting for Environmental Liabilities,* which requires (among other things) that an environmental liability be evaluated independently from any potential recovery, and that the loss arising from the recognition of an environmental liability should be reduced only when a claim for recovery is probable of realization. Additional accounting guidance in this area is included in FASB Interpretation No. 14, *Reasonable Estimation of the Amount of a Loss* (FASB, *Current Text,* vol. 1, sec. C59), FASB Interpretation No. 39, *Offsetting of Amounts Related to Certain Contracts* (FASB, *Current Text,* vol. 1, sec. B10), EITF Issue No. 89-13, *Accounting for the Cost of Asbestos Removal,* and EITF Issue No. 90-8, *Capitalization of Costs to Treat Environmental Contamination.*

Auditors of publicly held companies should also consider the requirements of SEC Staff Accounting Bulletin (SAB) No. 92, *Accounting and Disclosures Relating to Loss Contingencies,* which provides the SEC staff's interpretation of current literature related to the following:

- The inappropriateness of offsetting probable recoveries against probable contingent liabilities
- Recognition of liabilities for costs apportioned to other potential responsible parties
- Uncertainties in estimation of the extent of environmental or product liability
- The appropriate discount rate for environmental or product liabilities, if discounting is appropriate
- Accounting for environmental exit costs and related disclosures

- Financial statement disclosures and disclosure of certain information outside the basic financial statements

Audit Risk Alert—1995/96 contains further discussion of issues relating to environmental remediation matters. Also, refer to the "Accounting Developments" section of this Audit Risk Alert for information on AICPA Exposure Draft: *Proposed Statement of Position on Environmental Remediation Liabilities.*

Real Estate Investment Trusts

As discussed previously, the number of REIT offerings proliferated in the early 1990s. Beginning with the second half of 1994, however, interest rates began to rise. This resulted in an increased cost of capital for REITs, which was not necessarily offset by corresponding increases in the returns from properties owned. REIT share prices experienced a downturn, and initial public offering (IPO) activity decreased markedly.

REITs require new capital to fund acquisitions for growth. Because the market tends to penalize REITs that have high debt ratios (relative to other REITs), issuing debt is not considered an attractive alternative. This leaves REITs with several other alternatives, each of which presents issues that an auditor should be aware of.

Secondary Public Offerings. Although there have been recent successes in the secondary-public-offering marketplace, this avenue is more likely to be open only for REITs with highly successful past operating results. Those REITs that have not been as successful will be forced to pay higher underwriting costs and incentives to purchasers of the stock. The increased cost of capital, without a corresponding increase in return from the properties, results in decreased yields and cash flows.

Auditors should be aware of the competition involved for secondary-public-offering money. As REITs compete for this money, trusts may overvalue assets in order to increase their desirability to investors. Auditors should obtain reasonable assurance that the valuations of the assets and liabilities are reasonable.

Mergers and Acquisitions. The increased cost of capital to REITs, combined with the fact that the majority of property previously owned by the Resolution Trust Corporation has now been purchased, has made it more difficult for REITs to acquire properties at yields that substantially exceed a REIT's cost of capital. Additionally, a number of REITs have not met expectations that had been included in their offering materials. These factors serve to reduce the stock price of affected REITs, which in turn may make them acquisition candidates.

Auditors of REITs that may be acquisition candidates, such as those discussed above, should be aware of the possibility that trusts may overvalue assets in order to maintain a stock price at a level that would make them attractive to investors, but less attractive to potential acquiring entities. Auditors of larger, more successful REITs that may be looking to acquire other REITs also should be aware of this possibility.

Formation of Umbrella-Partnership Real Estate Investment Trusts. As a result of the downturn in IPO activity, many property owners found themselves unable or unwilling to proceed with planned IPOs. Many of these property owners are faced with "bullet" loans now coming due. These property owners may wish to consider the alternative of forming an umbrella-partnership real estate investment trust (UP-REIT). Also, for reasons discussed below, a traditional REIT may wish to convert itself to an UP-REIT in order to place itself in an advantageous position for future property acquisitions.

In the formation of a typical UP-REIT, an operating partnership is formed by a sponsor. The sponsor contributes real estate properties and related debt to the operating partnership. The exchange typically is accounted for as a reorganization of entities under common control in a manner similar to a pooling of interests. Accordingly, the contributed assets and liabilities are accounted for by the operating partnership at the sponsor's historical cost.

Concurrent with the formation of the operating partnership, a REIT invests proceeds from a public offering in exchange for a majority interest (general partner) in the operating partnership; the sponsor retains a minority interest in the operating partnership. Because of its controlling financial interest, the REIT consolidates the operating partnership in its financial statements. In the typical UP-REIT structure, the REIT's consolidated financial statements report the assets and liabilities contributed by the sponsor at the sponsor's historical cost basis.

The accounting issue discussed in EITF Issue No. 94-2, *Treatment of Minority Interests in Certain Real Estate Investment Trusts,* involves the question of how, and at what amount, the sponsor's minority interest should be reported in the REIT's consolidated financial statements. The EITF reached a consensus that the sponsor's interest in the operating partnership should be reported as a minority interest. The SEC staff has indicated, on the related issue of the appropriate carrying amount of the REIT's interest in the operating partnership, that the assets and liabilities contributed by the promoters of the offering (and in certain cases, other stockholders) should continue to be recorded at their historical-cost basis in the consolidated REIT financial statements pursuant to SAB No. 48, *Staff Position on Transfer of Assets by Promoters and Shareholders*. This conclusion is based on the SEC staff's view that the operating partnership itself has no significant substance outside tax considerations. Therefore, the typical REIT structure is usually, in substance, a reorganization and subsequent IPO.

When property owners look to sell their properties on a tax-deferred basis, an UP-REIT can acquire the property in question by exchanging limited partnership units for it, thus postponing the taxable gain that the seller would have been required to recognize had it sold the property.

During the year, the EITF discussed several matters that may affect the appropriate accounting for investments in joint ventures. Those matters include—

- Issue No. 95-6, *Accounting by a Real Estate Investment Trust for an Investment in a Service Corporation*, which sets forth criteria for determining whether significant influence exists. While the criteria were developed specifically for real estate investment trusts and service corporations, they may be useful in making that determination for other entities as well.
- Issue No. 94-1, *Accounting for Tax Benefits Resulting from Investments in Affordable Housing Projects*, which describes the Task Force's consensus position about how an entity that invests in a qualified affordable housing project through a limited partnership should account for its investment.
- Appendix D-46, *Accounting for Limited Partnership Investments*, which describes discussion of the SEC staff's position that investments in all limited partnerships should be accounted for pursuant to paragraph 8 of SOP 78-9, *Accounting for Investments in Real Estate Ventures*. That guidance requires the use of the equity method unless the investor's interest "is so minor that the limited partner may have virtually no influence over partnership operating and financial policies."

Auditors should consider these developments as they evaluate the appropriateness of real estate enterprise's accounting for investments in joint ventures and similar entities.

In addition to evaluating the propriety of the entity's method of accounting for an investment in joint ventures, the auditor should be aware that such arrangements may create relationships that meet the definition of related parties as set forth in FASB Statement No. 57. Auditors should consider the guidance contained in SAS No. 45, *Omnibus Statement on Auditing Standards—1983*, "Related Parties," which outlines procedures to identify related party relationships and transactions, and to assess the propriety of the required financial statement accounting and the adequacy of related disclosures.

Liquidity/Cash Flow Information

The SEC staff has noted that SEC registrants are expected to use the statement of cash flows and other appropriate indicators in analyzing their liquidity, and to present a balanced discussion in the Management's Discussion and Analysis (MD&A) section of SEC filings that addresses the cash flows from investing and financing activities, as well as from operations. A discussion of cash flow from operations by itself is not considered an appropriate presentation. If cash flow information is included in the Selected Financial Data section of SEC filings, it should also be presented in a balanced manner, including cash flows from operations, investing, and financing activities. The SEC staff has also indicated that, in the context of amounts available for distributions, it is more appropriate to discuss "cash available for distribution" than cash flow from operations, since distributions will be paid from available cash. SAS No. 8, *Other Information in Documents Containing Audited Financial Statements* (AICPA, *Professional Standards,* vol. 1, AU sec. 550), requires that auditors read such information and consider whether the information, or the manner of its presentation, is materially inconsistent with that appearing in the financial statements.

Non-GAAP Measures of Performance

The SEC staff notes that, increasingly, publicly held real estate entities have been presenting operating income before depreciation and amortization and writedowns of real estate (or, in some cases, funds from operations) in Selected Financial Data and MD&A. The SEC staff believes that such a caption is inappropriate in financial statements because it suggests that the amount represents cash flow for the period, which is rarely the case. Cash flow from operations is the appropriate caption, which must be included in a balanced presentation with cash flows from investing and financing activities in MD&A and elsewhere. Auditors of public entities should read such information and consider whether the information, or the manner of its presentation, is materially inconsistent with that appearing in the financial statements.

The SEC staff has noted that funds from operations (FFO) has been discussed outside of the financial statements in several recent filings with the SEC. Neither GAAP nor the authoritative accounting literature provides a definition for FFO, and the SEC staff's view with respect to the presentation of a cash flow measure as a proxy for net income and the presentation of Funds Generated from Operations are expressed in Accounting Series Release (ASR) 142. ASR 142 states that if such measurements of economic performance are presented in the MD&A section or elsewhere, they should not be presented in a manner that gives them greater authority or prominence than conventionally computed earnings. In no event should the presentation leave the reader with the impression that FFO is the appropriate measure of operating performance for the REIT and an appropriate measure for which dividends are computed and based. Net income and cash flows from operating, investing, and financing activities remain the appropriate measurements.

Investments in Derivatives

Recent years have seen a growing use of innovative financial instruments, commonly referred to as derivatives, that often are very complex and can involve a substantial risk of loss. As interest rates, commodity prices, and many other market rates and indices from which certain financial instruments (derivatives) derive their value have been volatile over the past several months, several entities have incurred significant losses because of their use. Real estate enterprises sometimes use derivatives as risk management tools or as speculative investment vehicles. The use of derivatives often increases audit risk. Although financial statement assertions about derivatives are generally similar to assertions about other transactions, the auditor's approach to achieving related audit objectives may differ because the notional and contractual amounts of certain derivatives—such as futures, forwards, swaps, options, and other contracts with similar characteristics—are not generally recognized in the financial statements.

Auditors should understand both the economics of derivatives used by an entity and the nature and business purpose of the entity's derivatives activities. In addition, auditors should evaluate accounting for any such instruments, especially those reported at amounts other than fair value. To the extent the derivatives qualify as financial instruments as defined in FASB Statements No. 105, *Disclosure of Information about Financial Instruments with Off-Balance-Sheet Risk and Financial Instruments with Concentrations of Credit Risk* (FASB, *Current Text,* vol. 1, sec. F25), No. 107, *Disclosures about Fair Value of Financial Instruments* (FASB, *Current Text,* vol. 1, sec. F25), and No. 119, *Disclosure about Derivative Financial Instruments and Fair Value of Financial Instruments* (FASB, *Current Text,* vol. 1, sec. F25), the disclosure requirements set forth in those statements must be met. When derivatives are accounted for as hedges of on-balance-sheet assets or liabilities or of anticipated transactions, auditors should carefully review the appropriateness of the use of hedge accounting, particularly considering whether the criteria set forth in applicable authoritative accounting literature are met.

Audit risk considerations presented by the use of derivatives are discussed in *Audit Risk Alert—1995/96*. The AICPA publication *Derivatives—Current Accounting and Auditing Literature* (Product No. 014888) summarizes current authoritative accounting and auditing guidance and provides background information on basic derivatives contracts, risks, and other general considerations. (See "Disclosures About Derivatives" in the "Accounting Developments" section herein.)

An advisory council to the Committee of Sponsoring Organizations of the Treadway Commission (COSO) has been preparing a guide on applying COSO's *Internal Control—Integrated Framework* to derivatives activities. COSO plans to issue a final guide in 1996.

Elimination of Uncertainty Reporting

The AICPA's Auditing Standards Board (ASB) has issued an exposure draft of a proposed SAS, *Amendment to Statement on Auditing Standards No. 58,* Reports on Audited Financial Statements, that would eliminate the requirement that, when certain criteria are met, the auditor add an uncertainties explanatory paragraph to the auditor's report.

The amendment would also expand the guidance in paragraph 37 of SAS No. 58, *Reports on Audited Financial Statements* (AICPA, *Professional Standards,* vol. 1, AU sec. 508), to indicate that "unusually important risks or uncertainties associated with contingencies, significant estimates, or concentrations" are matters that auditors may wish to emphasize in their reports. The amendment retains the option allowing auditors to disclaim an opinion on financial statements due to uncertainties.

The proposal does not affect the provisions of SAS No. 59, which requires that the auditor add an explanatory paragraph to the auditor's report if there is substantial doubt about the entity's ability to continue as a going concern.

The ASB hopes to finalize this SAS late this year and to issue a SAS that would be effective for reports issued on or after June 30, 1996. Comments on the proposed SAS were due on October 20, 1995.

Accounting Developments

Impairment of Long-Lived Assets

In March 1995, the FASB issued Statement No. 121 which establishes accounting standards for the impairment of long-lived assets, certain identifiable intangibles, and goodwill related to those assets to be held and used, and for long-lived assets and certain identifiable intangibles to be disposed of. The Statement requires that long-lived assets and certain identifiable intangibles to be held and used by an entity be reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. In performing the review for recoverability, the Statement requires that the entity estimate the future cash flows expected to result from the use of the asset and its eventual disposition. If the sum of the expected future cash flows (undiscounted and without interest charges) is less than the carrying amount of the asset, an impairment loss is recognized. Otherwise, an impairment loss is not recognized. Measurement of an impairment loss for long-lived assets and identifiable intangibles that an entity expects to hold and use should be based on the fair value of the asset. (The fair value of an asset is the amount at which that asset could be bought or sold in a current transaction between willing parties.)

The Statement also requires that long-lived assets and certain identifiable intangibles to be disposed of be reported at the lower of carrying amount or fair value less cost to sell, except for assets covered by APB Opinion No. 30. Assets covered by APB Opinion No. 30 will continue to be reported at the lower of the carrying amount or the net realizable value.

The Statement is effective for financial statements for fiscal years beginning after December 15, 1995. Earlier application is encouraged. Restatement of previously issued financial statements is not permitted by the Statement. The Statement requires that impairment losses resulting from its application be reported in the period in which the recognition criteria are first applied and met. The Statement requires that initial application of its provisions to assets that are being held for disposal at the date of adoption should be reported as the cumulative effect of a change in accounting principle.

FASB Statement No. 121 has particular importance to the real estate industry. It amends FASB Statement No. 67, *Accounting for the Costs and Initial Rental Operations of Real Estate Projects* (FASB, *Current Text*, vol. 2, sec. Re 2), by requiring that "a real estate project, or parts thereof, that is substantially complete and ready for its intended use shall be accounted for at the lower of carrying amount or fair value less costs to sell." Under FASB Statement No. 67, such real estate projects were accounted for at the lower of cost or net realizable value.

Further, as previously discussed, current economic conditions suggest slow revenue growth for some real estate enterprises. As a means of increasing profits, cost reduction efforts may be implemented. This could, for example, delay planned capital outlays intended to refurbish or replace existing productive assets. Additionally, environmental regulations may impose restrictions on the use of a long-lived asset, thus significantly reducing its ability to generate future cash flows. In such instances, the carrying amounts of recorded assets may not be recoverable and the provisions of FASB Statement No. 121 may need to be applied.

In considering a real estate enterprise's implementation of FASB Statement No. 121, auditors should obtain an understanding of the policies and procedures used by management to determine whether all impaired assets have been properly identified. Management's estimates of future cash flows from asset use and impairment losses should be evaluated pursuant to the guidelines set forth in SAS No. 57.

Disclosures About Derivatives

In October 1994, the FASB issued Statement No. 119, which requires disclosures about derivative financial instruments—futures, forward, swap, and option contracts, and other financial instruments with similar characteristics. It also amends existing requirements of FASB Statements No. 105 and No. 107.

The Statement requires disclosures about amounts, nature, and terms of derivative financial instruments that are not subject to FASB Statement No. 105 because they do not result in off-balance-sheet risk of accounting loss. It requires that a distinction be made between financial instruments held or issued for trading purposes (including dealing and other trading activities measured at fair value with gains and losses recognized in earnings) and financial instruments held or issued for purposes other than trading. Paragraph 12 of FASB Statement No. 119 encourages, but does not require, entities to disclose quantitative information about risks associated with derivatives.

FASB Statement No. 119 was effective for financial statements issued for fiscal years ending after December 15, 1994, except for institutions with less than $150 million in total assets. For those institutions, the Statement is effective for financial statements issued for fiscal years ending after December 15, 1995.

The FASB Special Report, *Illustrations of Financial Instrument Disclosures*, contains illustrations of the application of FASB Statements No. 105, No. 107, and No. 119, including specific illustrations of application by a domestic and an international financial institution.

FASB Statements on Loan Impairment

In May 1993, FASB Statement No. 114, *Accounting by Creditors for Impairment of a Loan* (FASB, *Current Text*, vol. 1, sec. I08), was issued to address the accounting by creditors for the impairment of certain loans. A loan is impaired when, based on current information and events, it is probable that a creditor will be unable to collect all amounts due according to the contractual terms of the loan agreement. The Statement is applicable to all creditors and to all loans, uncollateralized as well as collateralized, except large groups of smaller balance homogeneous loans that are collectively evaluated for impairment, loans that are measured at fair value or at the lower of cost or fair value, leases, and debt securities as defined in FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities* (FASB, *Current Text,* vol. 1, sec. I80). It applies to all loans that are restructured in a troubled debt restructuring involving a modification of terms.

FASB Statement No. 114 requires that impaired loans that are within its scope be measured based on the present value of expected future cash flows discounted at the loan's effective interest rate or, as a practical expedient, at the loan's observable market price or the fair value of the collateral if the loan is collateral-dependent. The impairment is recognized by creating or adjusting a valuation allowance for the loan with a corresponding charge to bad debt expense.

FASB Statement No. 114 amends FASB Statement No. 5 to clarify that a creditor should evaluate the collectibility of both the contractual interest and contractual principal of all receivables when assessing the need for a loss accrual. The Statement also amends FASB Statement No. 15 to require a creditor to measure all loans that are restructured in a troubled debt restructuring involving a modification of terms in accordance with its provisions.

The Statement applies to financial statements for fiscal years beginning after December 15, 1994.

In October 1994, the FASB issued Statement No. 118, *Accounting by Creditors for Impairment of a Loan—Income Recognition and Disclosures* (FASB, *Current Text,* vol. 1, sec. I08). FASB Statement No. 118 amends FASB Statement No. 114 to allow creditors to use existing methods for recognizing interest income on impaired loans. To accomplish that, it eliminates the provisions in FASB Statement No. 114 that describe how creditors should report income on impaired loans.

FASB Statement No. 118 does not change the provisions in FASB Statement No. 114 that require creditors to measure impairment based on the present value of expected future cash flows discounted at the loan's effective interest rate, or as a practical expedient, at the observable market price of the loan or the fair value of the collateral if the loan is collateral-dependent.

FASB Statement No. 118 also amends the disclosure requirements in FASB Statement No. 114 to require the disclosure of information about the recorded investment in certain impaired loans and about how creditors recognize interest income related to those loans.

FASB Statement No. 118 is effective concurrent with the effective date of FASB Statement No. 114, that is, for financial statements for fiscal years beginning after December 15, 1994.

Discussions of the EITF

The EITF frequently discusses accounting issues involving financial instruments, real estate, or transactions of similar importance to real estate enterprises. A description of issues discussed during the year follows; readers should consult detailed minutes for additional information.

EITF Issue No. 94-1. The Omnibus Budget Reconciliation Act of 1993 retroactively extended and made permanent the low-income housing credit that expired after June 30, 1992. Investors in limited partnerships operating qualified low-income housing projects earn tax credits over a ten-year period to encourage such investments. The issue is whether a limited-partner (investor) should account for its investment as a tax benefit acquired or as an investment in real estate. The EITF reached a consensus that an entity that invests in a qualified affordable housing project through a limited partnership investment may elect to account for the investment using the effective yield method if all of the following conditions are met:

a. The availability (but not necessarily the realization) of the tax credits allocable to the investor is guaranteed by a creditworthy entity through a letter of credit, a tax indemnity agreement, or another similar arrangement.

b. The investor's projected yield based solely on the cash flows from the guaranteed tax credits is positive.

c. The investor is a limited partner in the affordable housing project for both legal and tax purposes and the investor's liability is limited to its capital investment.

Limited partnership investments in qualified affordable housing projects not accounted for using the effective yield method, should be accounted for in accordance with SOP 78-9.

The EITF also reached a consensus that an investor using the cost method should amortize any excess of the carrying amounts of the investment over its estimated residual value during the periods in which tax credits are allocated to the investor.

The EITF also reached a consensus that a limited partnership investment in a qualified affordable housing project should be reviewed periodically for impairment.

The EITF also reached a consensus that a liability should be recognized for delayed equity contributions that are unconditional and legally binding. A liability should be recognized for equity contributions that are contingent upon a future event if that contingent event becomes probable.

EITF Issue No. 94-2. As discussed previously, the SEC staff has concluded that the carrying amounts of the operating partnership's assets and liabilities in the REIT's consolidated financial statements should be the promoter's historical-cost basis in those assets and liabilities (that is, the carrying amounts of the assets and liabilities are not changed as a result of the formation of the REIT). This issue addresses the appropriate accounting for the minority interest shown in the REIT's consolidated financial statements. The EITF reached a consensus that the sponsor's interest in the operating partnership should be reported as a minority interest in the REIT's consolidated financial statements. The EITF also agreed that the net equity of the operating partnership (after the contributions of the sponsor and the REIT) multiplied by the sponsor's ownership percentage in the operating partnership represents the amount to be reported as the minority interest in the REIT's consolidated financial statements.

Risks and Uncertainties

In December 1994, AcSEC issued SOP 94-6, *Disclosure of Certain Significant Risks and Uncertainties.* SOP 94-6 requires nongovernmental entities to include in their financial statements disclosures about (1) the nature of their operations and (2) the use of estimates in the preparation of financial statements. In addition, if specified criteria are met, SOP 94-6 requires entities to include in their financial statements disclosures about (1) certain significant estimates and (2) current vulnerability due to certain concentrations.

Paragraph 18 of SOP 94-6 gives examples of items that may be based on estimates that are particularly sensitive to change in the near term. Examples of estimates that may be included in the financial statements of real estate enterprises are:

- Impairment of long-lived assets
- Estimates of environmental remediation liabilities
- Profit recognition on sales recognized on the installment method

Examples of concentrations that may be subject to disclosure in the financial statements of real estate enterprises may include the following:

- Ownership of numerous properties within one geographical area

- Leases with one lessee
- Funding commitments from one financial institution related to project development

The provisions of SOP 94-6 are effective for financial statements issued for fiscal years ending after December 15, 1995, and for financial statements for interim periods in fiscal years subsequent to the year for which SOP 94-6 is first applied.

Auditors should be alert to the requirements of the new SOP and its impact on the financial statements they audit. Auditors should carefully consider whether all significant estimates and concentrations have been identified and considered for disclosure.

AICPA Exposure Draft: Proposed Statement of Position on Environmental Remediation Liabilities

Under environmental laws and regulations, real estate enterprises may be held responsible for cleanup costs related to various aspects of their operations.

In June 1995, the AICPA issued an exposure draft of a proposed SOP, *Environmental Remediation Liabilities.* The exposure draft provides that—

- Environmental remediation liabilities should be accrued when the criteria of FASB Statement No. 5 are met, and it includes benchmarks to aid in determining when those criteria are met.
- Accruals for environmental remediation liabilities should include (1) incremental direct costs of the remediation effort, as defined, and (2) costs of compensation and benefits for employees to the extent the employees are expected to devote time to the remediation effort.
- Measurement of the liabilities should include (1) the entity's specific share of the liability for a specific site, and (2) the entity's share of amounts related to the site that will not be paid by other potentially responsible parties or the government.
- Measurement of the liability should be based on enacted laws and existing regulations, policies and remediation technology.
- Measurement should be based on the reporting entity's estimates of what it will cost to perform all elements of the remediation effort when they are expected to be performed, and may be discounted to reflect the time value of money if the aggregate amount of the obligation and the amount and timing of cash payments for a site are fixed or reliably determinable.

The exposure draft also includes guidance on display in the financial statements of environmental remediation liabilities and on disclosures about environmental-cost-related accounting principles, environmental remediation loss contingencies, and other loss contingency disclosure considerations. A separate, nonauthoritative section of the exposure draft discusses major federal environmental pollution responsibility and clean-up laws and the need to consider various individual state and other non-United States government requirements.

Comments on the exposure draft were due by October 31, 1995.

Auditors should be aware of the requirements of the proposed SOP and of the fact that ownership of real estate often exposes entities to environmental remediation liabilities.

AICPA Exposure Draft: Proposed Statement of Position on Participating Mortgage Loan Borrowers

In July 1995, the AICPA issued an exposure draft of a proposed SOP, *Accounting by Participating Mortgage Loan Borrowers*. The proposed SOP establishes the borrower's accounting for a participating mortgage loan if the lender participates in increases in the market value of the mortgaged real estate project, the results of operations of that mortgaged real estate project, or both.

Information Sources

Further information on matters addressed in this risk alert is available through various publications and services listed in the table at the end of this document. Many non-government and some government publications and services involve a charge or membership requirement.

Fax services allow users to follow voice cues and request that selected documents be sent by fax machine. Some fax services require the user to call from the handset of the fax machine, others allow users to call from any phone. Most fax services offer an index document, which lists titles and other information describing available documents.

Electronic bulletin board services allow users to read, copy, and exchange information electronically. Most are available using a modem and standard communications software. Some bulletin board services are also available using one or more Internet protocols.

Recorded announcements allow users to listen to announcements about a variety of recent or scheduled actions or meetings.

All phone numbers listed are voice lines, unless otherwise designated as fax (f) or data (d) lines. Required modem speeds, expressed in bauds per second (bps), are listed data lines.

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This Audit Risk Alert supersedes Real Estate Industry Developments—1994.

* * * *

Practitioners should also be aware of the economic, industry, regulatory, and professional developments described in *Audit Risk Alert—1995/96* and *Compilation and Review Alert—1995/96*, which may be obtained by calling the AICPA Order Department at the number below and asking for product no. 022180 (audit) or 060669 (compilation and review).

Information Sources

Organization	General Information	Fax Services	Electronic Bulletin Board Services	Recorded Announcements
American Institute of Certified Public Accountants	*Order Department* Harborside Financial Center 201 Plaza Three Jersey City, NJ 07311-3881 (800) TO-AICPA or (800) 862-4272 Information about AICPA continuing professional education programs is available through the AICPA CPE Division (ext. 3) and the AICPA Meetings and Travel Division: (201) 938-3232.	*24 Hour Fax Hotline* (201) 938-3787	*Accountants Forum* This information service is available on CompuServe. Some information is available only to AICPA members. To set up a CompuServe account call (800) 524-3388 and ask for the AICPA package or rep. 748.	
Financial Accounting Standards Board	*Order Department* P.O. Box 5116 Norwalk, CT 06856-5116 (203) 847-0700, ext. 10			*Action Alert Telephone Line* (203) 847-0700 (ext. 444)
U.S. General Accounting Office	*Superintendent of Documents* U.S. Government Printing Office Washington, DC 20401-0001 (202) 512-1800 (202) 512-2250 (f)		*U.S. Government Printing Office's The Federal Bulletin Board* Includes *Federal Register* notices and the Code of Federal Regulations. Users are usually expected to open a deposit account. User assistance line: (202) 512-1530 (202) 512-1387 (d) Telnet via internet: federal.bbs.gpo.gov 3001	
U.S. Securities and Exchange Commission	*Publications Unit* 450 Fifth Street, NW Washington, DC 20549-0001 (202) 942-4046 *SEC Public Reference Room* (202) 942-8079	*Information Line* (202) 942-8088, ext. 3 (202) 942-7114 (tty)		*Information Line* (202) 942-8088 (202) 942-7114 (tty)

Non-Authoritative Practice Aid: Illustrative Independent Auditor Reports Based on Audits Performed in Accordance With the *Consolidated Audit Guide for Audits of HUD Programs* Issued by the U.S. Department of Housing and Urban Development, Office of Inspector General (July 1993 Edition)

[*Note*: This appendix provides sample reports included in Chapter 2 of the HUD Handbook 2000.04 REV-1 as amended by the 1994 revision to *Government Auditing Standards*, which was effective for financial audits of periods ending on or after January 1, 1995 (early application is permissible). These illustrative reports are intended to be a non-authoritative practice aid and have not been approved, disapproved, or otherwise acted on by a senior technical committee of the AICPA.]

EXAMPLE A

Report on Audited Financial Statements and Supplementary Information

Independent Auditor's Report

To the Partners
ABC Entity
Anytown, U.S.A.

We have audited the accompanying balance sheet of [*Entity*] as of June 30, 199X, and the related statements of income, and cash flows (and changes in partners' equity)(and analysis of net worth) for the year then ended. These financial statements are the responsibility of the [*Entity's*] management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with generally accepted auditing standards and *Government Auditing Standards,* issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of [*Entity*] as of June 30, 199X, and the results of its operations and its cash flows for the year then ended in conformity with generally accepted accounting principles.

In accordance with *Government Auditing Standards,* we have also issued a report dated [*date of report*] on our consideration of [*Entity's*] internal control structure and a report dated [*date of report*] on its compliance with laws and regulations.

The accompanying supplementary information (shown on pages XX to XY) is presented for purposes of additional analysis and is not a required part of the basic financial statements. Such information has been subjected to the auditing procedures applied in the audit of the basic financial statements and, in our opinion, is fairly stated in all material respects in relation to the financial statements taken as a whole.

[*Signature*]

[*Date*]

EXAMPLE B

Independent Auditor's Report on the Internal Control Structure (Combined Report Applicable to the Financial Statements and HUD-Assisted Programs—Reportable Conditions Were Noted—No Material Weaknesses)[1]

Independent Auditor's Report

[*Note*: The Consolidated Audit Guide for Audits of HUD Programs (July 1993 edition) illustrates a "combined" report on the internal control structure applicable to the financial statements and HUD-assisted programs. Accordingly, this illustration is a combined report. Auditors should exercise care in issuing such a combined report to assure that the unique requirements in the Guide and varying levels of materiality are met.]

To the Partners
ABC Partnership
Anytown, U.S.A.

We have audited the financial statements of [*Entity*] as of and for the year ended June 30, 199X, and have issued our report thereon dated [*date of report*].[2] We have also audited [*Entity's*] compliance with requirements applicable to major HUD-assisted programs and have issued our report thereon dated [*date of report*].

We conducted our audits in accordance with generally accepted auditing standards and *Government Auditing Standards*, issued by the Comptroller General of the United States and the *Consolidated Audit Guide for Audits of HUD Programs* (the "Guide"), issued by the U.S. Department of Housing and Urban Development, Office of the Inspector General in July 1993. Those standards and the Guide require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement and about whether [*Entity*] complied with laws and regulations, noncompliance with which would be material to a major HUD-assisted program.

The management of [*Entity*] is responsible for establishing and maintaining an internal control structure. In fulfilling this responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of internal

[1] For guidance on departures from the standard internal control structure report and examples of explanatory paragraphs, the auditor should consult AICPA Statement of Position 92-9, *Audits of Not-for-Profit Organizations Receiving Federal Awards*, Exhibit D-8, and AICPA Audit and Accounting Guide *Audits of State and Local Governmental Units*, Appendix A, Examples A.26(A) through A.26(E).

[2] Describe any departure from the standard report.

control structure policies and procedures. The objectives of an internal control structure are to provide management with reasonable, but not absolute, assurance that assets are safeguarded against loss from unauthorized use or disposition and that transactions are executed in accordance with management's authorization and recorded properly to permit the preparation of financial statements in accordance with generally accepted accounting principles and that HUD-assisted programs are managed in compliance with applicable laws and regulations. Because of inherent limitations in any internal control structure, errors, irregularities or instances of noncompliance may nevertheless occur and not be detected. Also, projection of any evaluation of the structure to future periods is subject to the risk that procedures may become inadequate because of changes in conditions or that the effectiveness of the design and operation of policies and procedures may deteriorate.

In planning and performing our audits, we obtained an understanding of the design of relevant internal control structure policies and procedures and determined whether they had been placed in operation, and we assessed control risk in order to determine our auditing procedures for the purpose of expressing our opinions on the financial statements of [*Entity*] and on its compliance with specific requirements applicable to its major HUD-assisted programs and to report on the internal control structure in accordance with the provisions of the Guide and not to provide any assurance on the internal control structure.

We performed tests of controls, as required by the Guide, to evaluate the effectiveness of the design and operation of internal control structure policies and procedures that we considered relevant to preventing or detecting material noncompliance with specific requirements applicable to [*Entity's*] major HUD-assisted programs. Our procedures were less in scope than would be necessary to render an opinion on such internal control structure policies and procedures. Accordingly, we do not express such an opinion.

We noted certain matters involving the internal control structure and its operation that we consider to be reportable conditions under standards established by the American Institute of Certified Public Accountants. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control structure that, in our judgment, could adversely affect the organization's ability to record, process, summarize, and report financial data consistent with management's assertions in the financial statements or to administer HUD-assisted programs in accordance with applicable laws and regulations.

[*Include paragraphs to describe the reportable conditions noted.*]

A material weakness is a reportable condition in which the design or operation of one or more of the internal control structure elements does not reduce to a relatively low level the risk that errors or irregularities in amounts that would be material in relation to the financial statements being audited or that noncompliance with laws and regulations that would be material to a HUD-assisted program may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions.

Our consideration of the internal control structure would not necessarily disclose all matters in the internal control structure that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses as defined above. However, we believe none of the reportable conditions described above is a material weakness.

We also noted other matters involving the internal control structure and its operation that we have reported to the management of [*Entity*] in a separate letter dated [*date of report*].

This report is intended for the information of the audit committee, management, and the Department of Housing and Urban Development. However, this report is a matter of public record and its distribution is not limited.

[*Signature*]

[*Date*]

EXAMPLE C

Independent Auditor's Report on Compliance Based on an Audit of Financial Statements—No Reportable Instances of Noncompliance[1]

Independent Auditor's Report

[*Note:* This report is not illustrated in the Consolidated Audit Guide for Audits of HUD Programs (July 1993 edition). As noted in the Guide, if the IA considered laws and regulations as part of the audit of the financial statements in addition to those noted in the Guide for which noncompliance could have a direct and material effect on the financial statements, as required by SAS No. 54, Illegal Acts by Clients, the auditor should also issue this report in accordance with Government Auditing Standards.]

To the Partners
ABC Partnership
Anytown, U.S.A.

We have audited the financial statements of [*Entity*] as of and for the year ended June 30, 19X1, and have issued our report thereon dated August 15, 19X1.[2]

We conducted our audit in accordance with generally accepted auditing standards and *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement.

Compliance with laws, regulations, contracts and grants applicable to [*Entity*] is the responsibility of the [*Entity's*] management. As part of obtaining reasonable assurance about whether the financial statements are free of material misstatement, we performed tests of [*Entity's*] compliance with certain provisions of laws, regulations, and contracts. However, the objective of our audit of the financial statements was not to provide an opinion on overall compliance with such provisions. Accordingly, we do not express such an opinion.

[1] For guidance on departures from the standard report on compliance based on an audit of the financial statements and examples of explanatory paragraphs, the auditor should consult AICPA Statement of Position 92-9, Exhibits D-4 through D-7, and the AICPA Audit and Accounting Guide *Audits of State and Local Governmental Units*, Appendix A, Example A.17(B).

[2] Describe any departure from the standard report.

The results of our tests disclosed no instances of noncompliance that are required to be reported herein under *Government Auditing Standards*.[3,4]

This report is intended for the information of the audit committee, management, and the Department of Housing and Urban Development. However, this report is a matter of public record and its distribution is not limited.

[*Signature*]

[*Date*]

[3] See *Government Auditing Standards*, Chapter 5, paragraphs 5.18 and 5.19, for reporting criteria.

[4] If the auditor has issued a separate letter to communicate irregularities, illegal acts, or other noncompliance that do not meet the criteria for reporting in paragraph 5.18 of *Government Auditing Standards*, this paragraph should be modified to include a statement such as the following:

> We noted certain immaterial instances of noncompliance that we have reported to the management of [Entity] in a separate letter dated August 15, 199X.

Independent Auditor's Report on Compliance With Specific Requirements Applicable to Major HUD Programs[1]

Independent Auditor's Report

To the Partners
ABC Partnership
Anytown, U.S.A.

We have audited the financial statements of [*Entity*] as of and for the year ended June 30, 199X and have issued our report thereon dated [*date of report*].[2]

We have also audited [*Entity's*] compliance with the specific program requirements governing (list those requirements tested) that are applicable to each of its major HUD-assisted programs, for the year ended June 30, 199X. The management of [*Entity*] is responsible for compliance with those requirements. Our responsibility is to express an opinion on compliance with those requirements based on our audit.

We conducted our audit in accordance with generally accepted auditing standards, *Government Auditing Standards,* issued by the Comptroller General of the United States, and the *Consolidated Audit Guide for Audits of HUD Programs* (the "Guide") issued by the U.S. Department of Housing and Urban Development, Office of Inspector General in July 1993. Those standards and the Guide require that we plan and perform the audit to obtain reasonable assurance about whether material noncompliance with the requirements referred to above occurred. An audit includes examining, on a test basis, evidence about [*Entity's*] compliance with those requirements. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, [*Entity*] complied, in all material respects, with the requirements described above that are applicable to each of its major HUD-assisted programs for the year ended June 30, 199X.

This report is intended for the information of the audit committee, management, and the Department of Housing and Urban Development. However, this report is a matter of public record and its distribution is not limited.

[*Signature*]

[*Date*]

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[1] For guidance on departures from the standard report on compliance with specific requirements applicable to major programs, auditors should consult AICPA Statement of Position 92-9, Exhibits D-9 through D-14, and the AICPA Audit and Accounting Guide *Audits of State and Local Governmental Units,* Appendix A, Examples A.18 through A.22.

[2] Describe any departures from the standard report.

Independent Auditor's Report on Compliance With Specific Requirements Applicable to Nonmajor HUD Programs Transactions

Independent Auditor's Report

To the Partners
ABC Partnership
Anytown, U.S.A.

We have audited the financial statements of [*Entity*] as of and for the year ended June 30, 199X, and have issued our report thereon dated [*date of report*].[1]

In connection with our audit of the 199X financial statements of [*Entity*] and with our consideration of [*Entity's*] internal control structure used to administer HUD programs, as required by the *Consolidated Audit Guide for Audits of HUD Programs* (the "Guide") issued by the U.S. Department of Housing and Urban Development in July 1993, we selected certain transactions applicable to certain nonmajor HUD-assisted programs for the year ended June 30, 199X. As required by the Guide, we performed auditing procedures to test compliance with the requirements governing [*list requirements tested*] that are applicable to those transactions. Our procedures were substantially less in scope than an audit, the objective of which is the expression of an opinion on [*Entity's*] compliance with these requirements. Accordingly, we do not express such an opinion.

The results of our tests disclosed no instances of noncompliance that are required to be reported herein under the Guide.[2]

This report is intended for the information of the audit committee, management, and the Department of Housing and Urban Development. However, this report is a matter of public record and its distribution is not limited.

[*Signature*]

[*Date*]

[1] Describe any departures from the standard report.

[2] If there are instances of noncompliance that are required to be reported under the Guide, this sentence should be deleted and the instances of noncompliance noted should be reported in this paragraph or in an attached schedule.

Independent Auditor's Report on Compliance With Specific Requirements Applicable to Affirmative Fair Housing

Independent Auditor's Report

To the Partners
ABC Partnership
Anytown, U.S.A.

We have audited the financial statements of [*Entity*] as of and for the year ended June 30, 199X, and have issued our report thereon dated [*date of report*].[1]

We have also applied procedures to test [*Entity's*] compliance with the Affirmative Fair Housing requirements applicable to its HUD assisted programs, for the year ended June 30, 199X.

Our procedures were limited to the applicable compliance requirement described in the *Consolidated Audit Guide for Audits of HUD Programs* (the Guide) issued by the U.S. Department of Housing and Urban Development, Office of Inspector General in July 1993. Our procedures were substantially less in scope than an audit, the objective of which is the expression of an opinion on [*Entity's*] compliance with the Affirmative Fair Housing requirements. Accordingly, we do not express such an opinion.

The results of our tests disclosed no instances of noncompliance that are required to be reported herein under the Guide.[2]

This report is intended for the information of the audit committee, management and the Department of Housing and Urban Development. However, this report is a matter of public record and its distribution is not limited.

[*Signature*]

[*Date*]

[1] Describe any departure from the standard report.

[2] If there are instances of noncompliance that are required to be reported under the Guide, his sentence should be deleted and the instances of noncompliance noted should be reported in this paragraph or in an attached schedule.

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